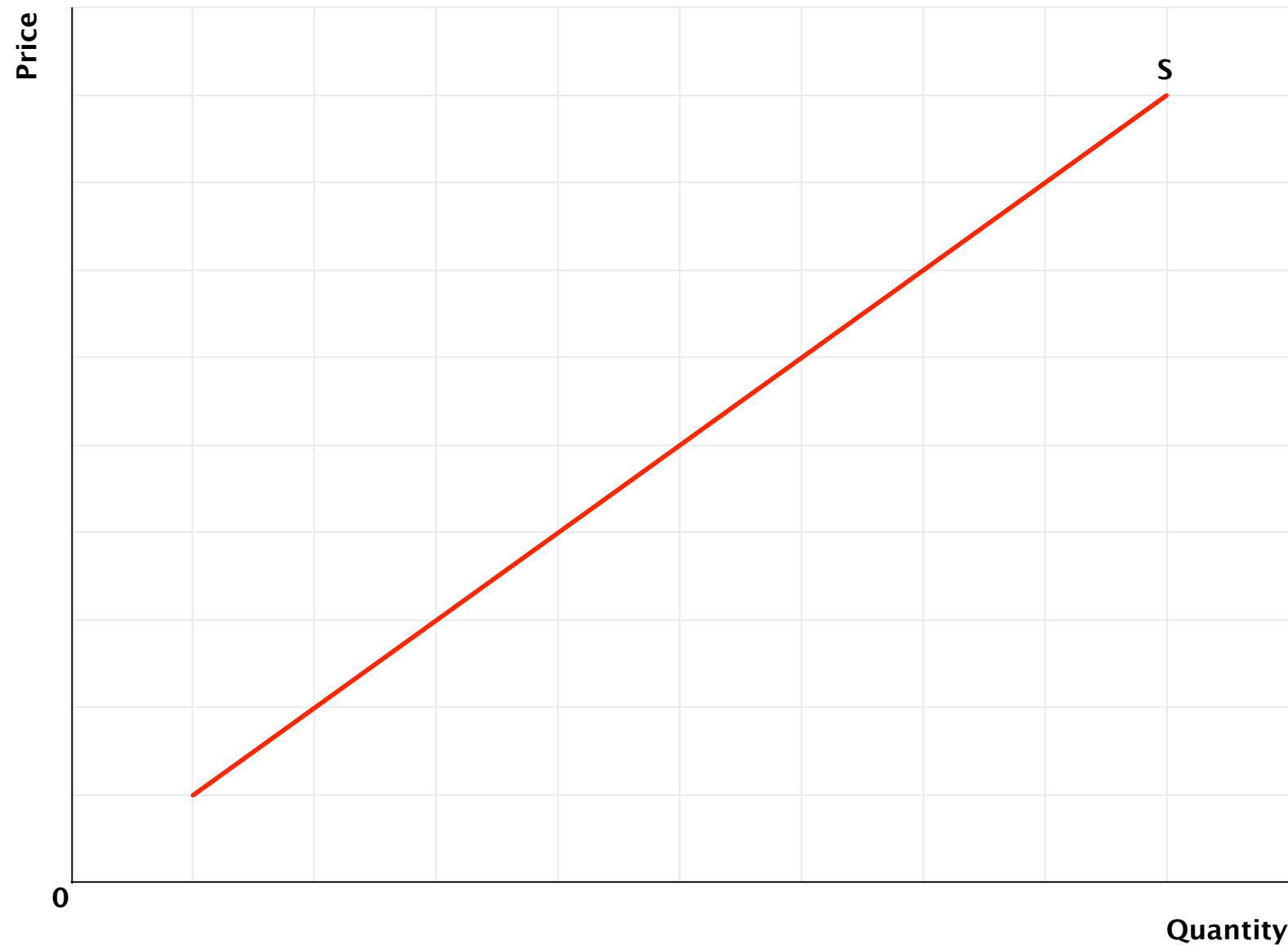


Aggregate Supply

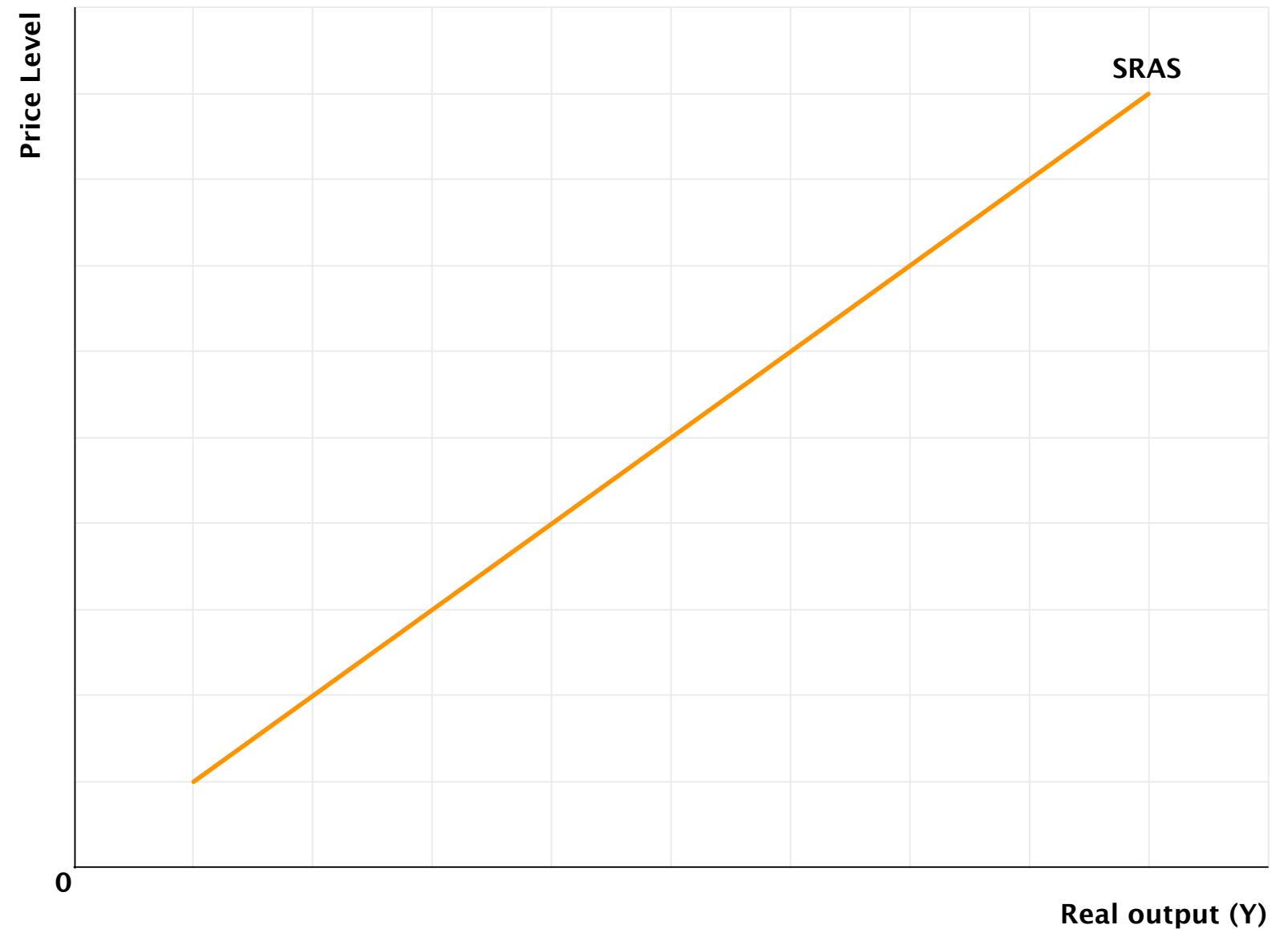
The supply of the entire economy

- **Aggregate supply:** the total amount of all goods and services that all industries in the economy will produce at every given price level.
- When looking at aggregate supply, it is very important to distinguish between the short run and the long run.

- **Short run aggregate supply (SRAS)** – looks very similar to **supply** from micro, but with some important differences:



SUPPLY



SRAS

Supply

Supply is concerned with one good or service.

Supply uses price on the Y axis.

Supply uses quantity on the X axis.

SRAS

SRAS is concerned with all goods and services.

SRAS uses price level on the Y axis.

SRAS uses real output/
real income/Y on the X axis.

Supply

As price \uparrow , $Q_s \uparrow$ and vice versa.

A Δ in S means the entire curve moves left or right.

A Δ in P means we move along the curve.

SRAS

As price level \uparrow , $Y \uparrow$ and vice versa.

A Δ in SRAS means the entire curve moves left or right.

A Δ in PL means we move along the curve.

- A change in something besides the price level will result in a shift of SRAS.

Costs of production

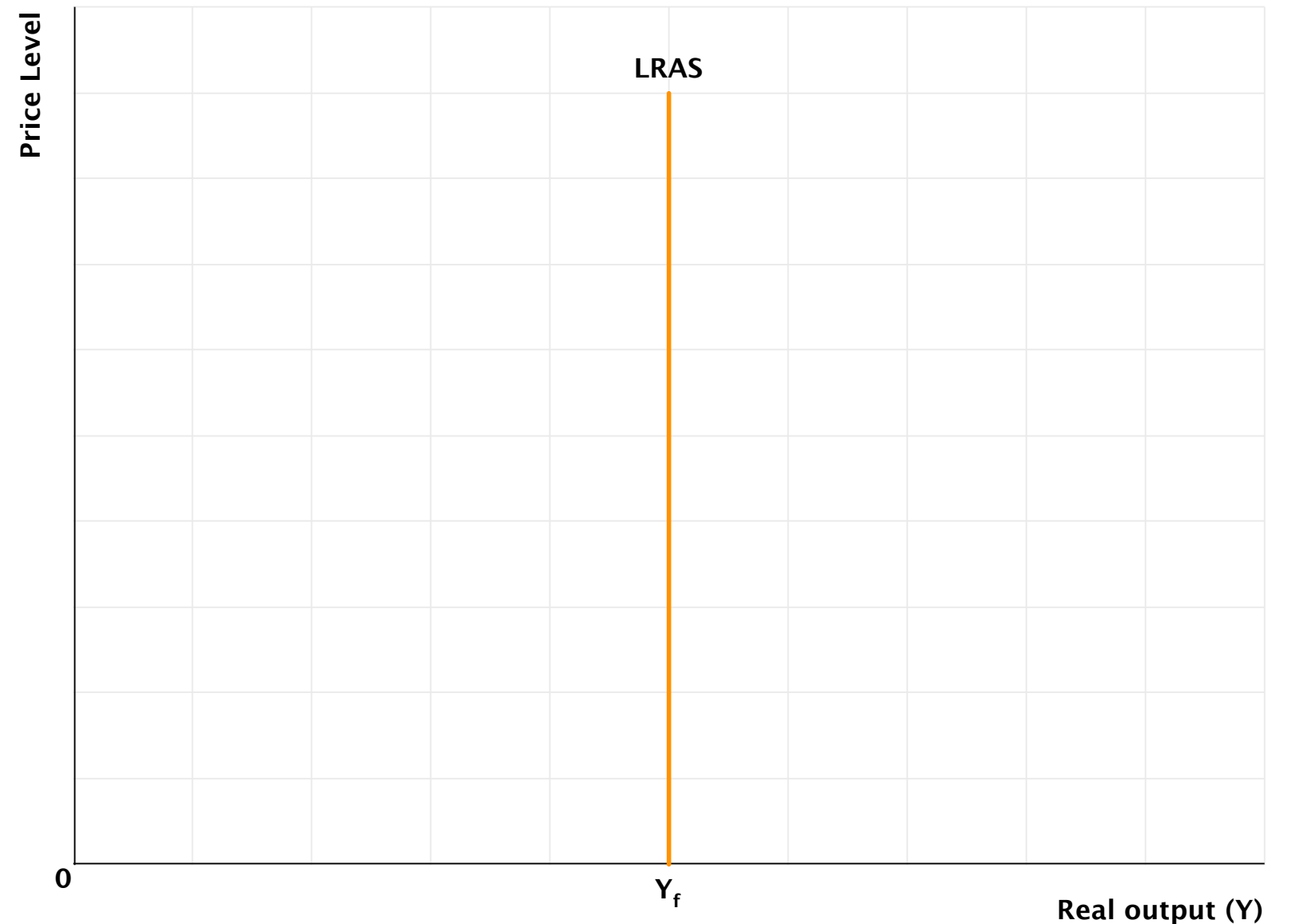
- A change in wage rates.
- A change in the cost of raw materials.
- A change in the price of imports.
- A change in government indirect taxes or subsidies.

Long run aggregate supply

- The shape of the LRAS is a subject of important debate.
- There are two viewpoints of LRAS:
 - New classical or neo-classical or monetarist
 - Keynesian
- Policy recommendations depend on the way one views LRAS.

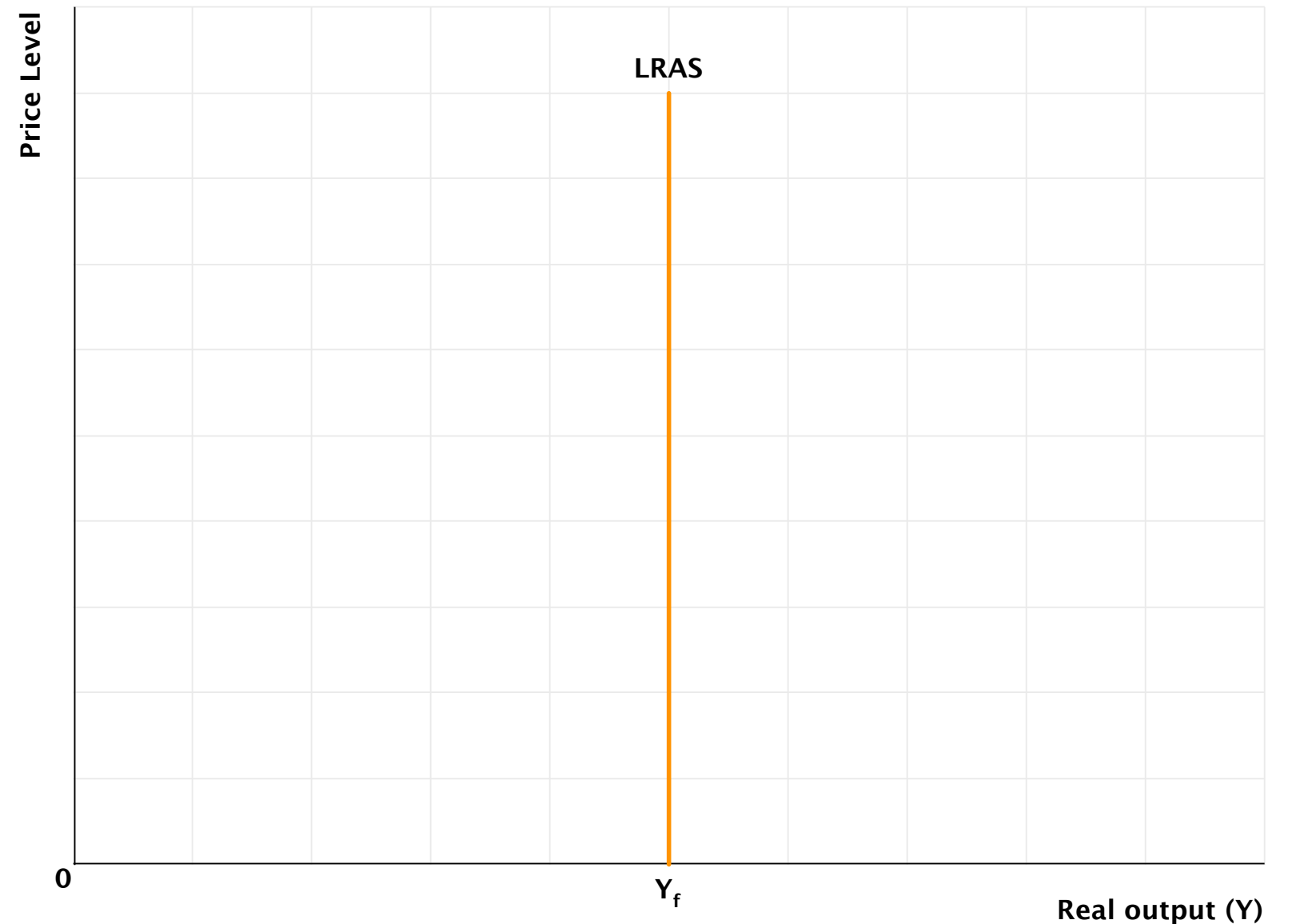
New classical LRAS

- The LRAS is perfectly inelastic at the “full employment level of output” – Y_f .
- This means that all factors of production are being fully utilized.
- This is the same idea as producing on the PPC.



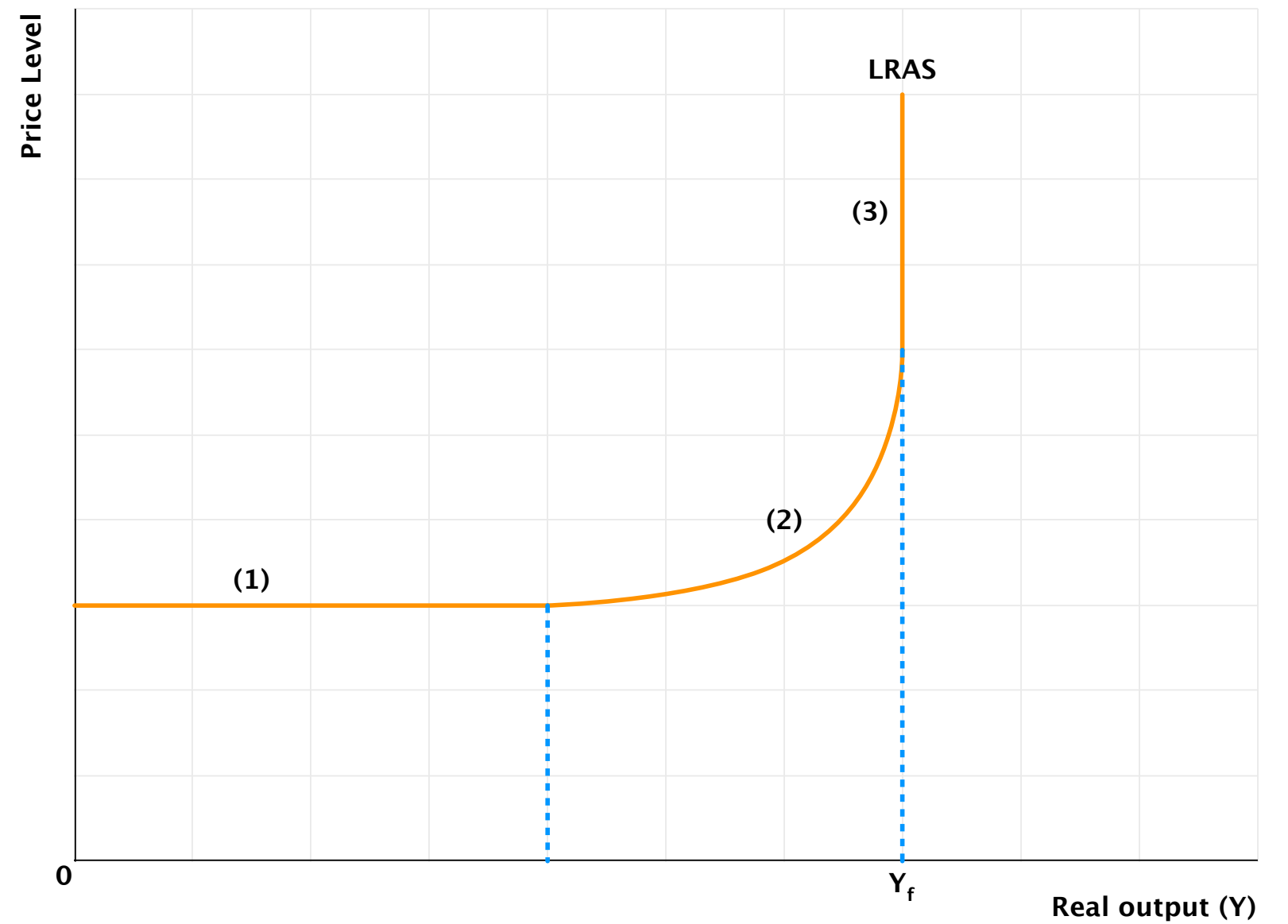
New classical LRAS

- Real output depends entirely on the quantity and quality of the factors of production.
- Note: there is still some unemployment, which will be covered in a future chapter.



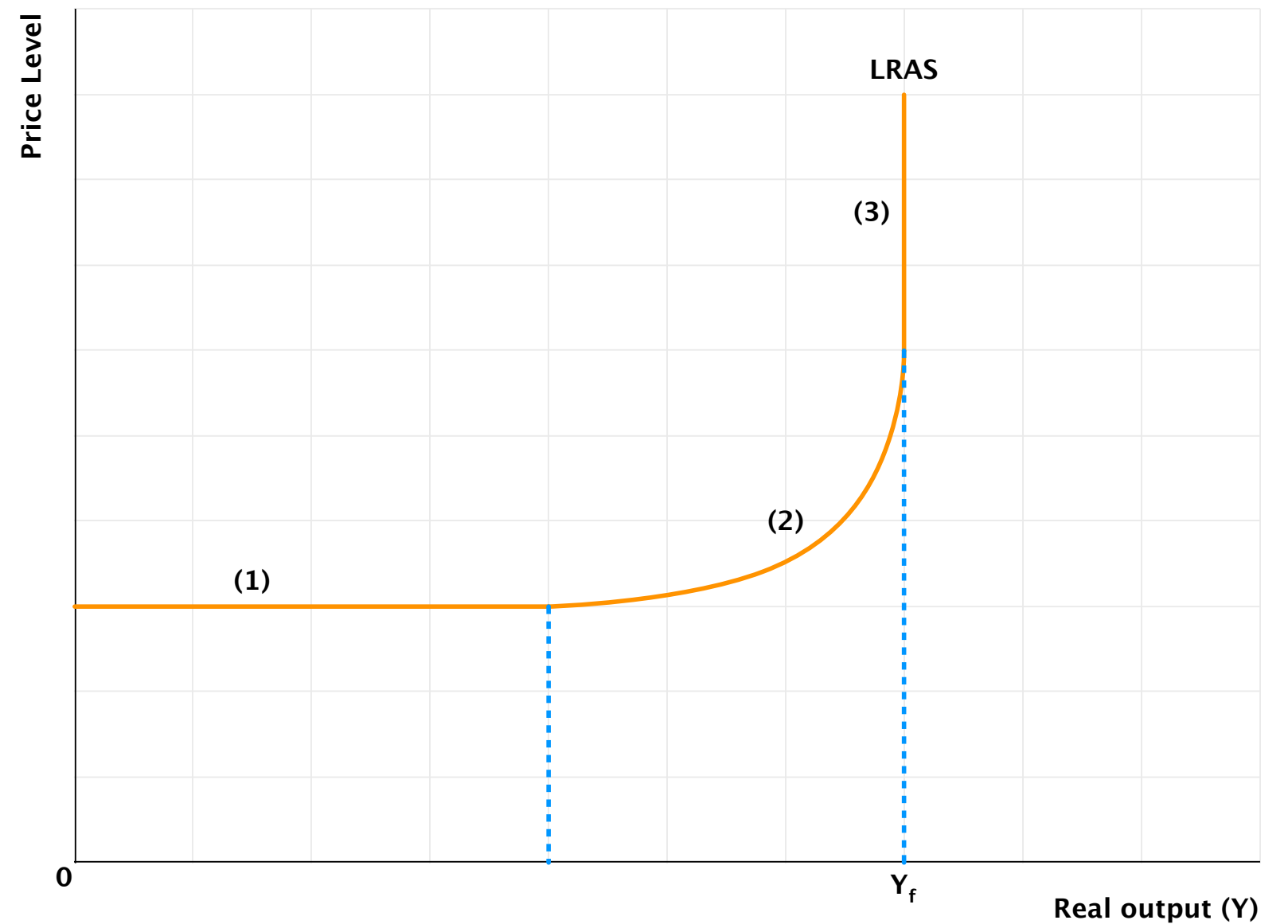
Keynesian LRAS

- Keynesian LRAS has three distinct regions.



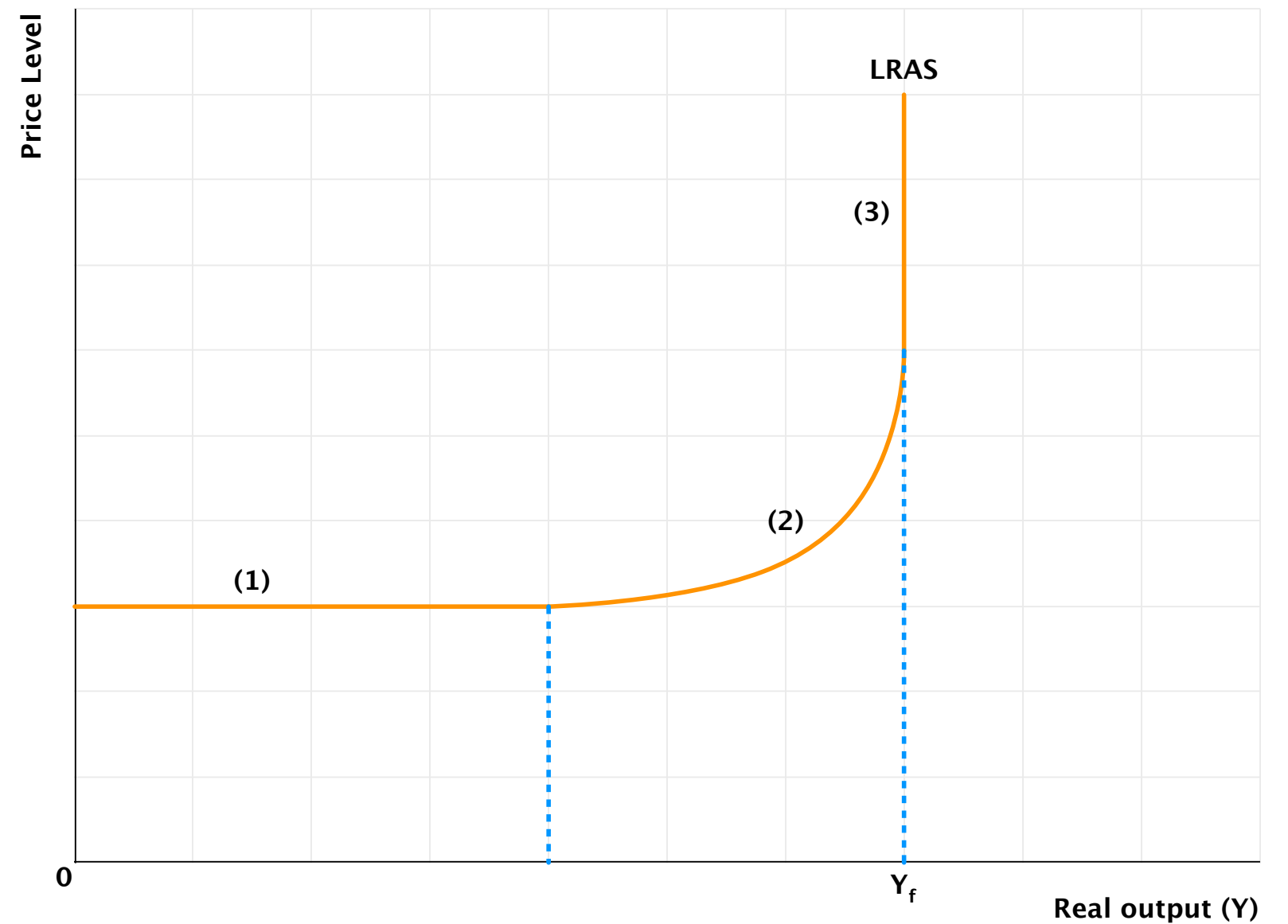
Keynesian LRAS

- In region (1), the LRAS is perfectly elastic.
- There is “spare capacity” or lots of unused factors of production.
- Using more factors of production will not cause the PL to increase.



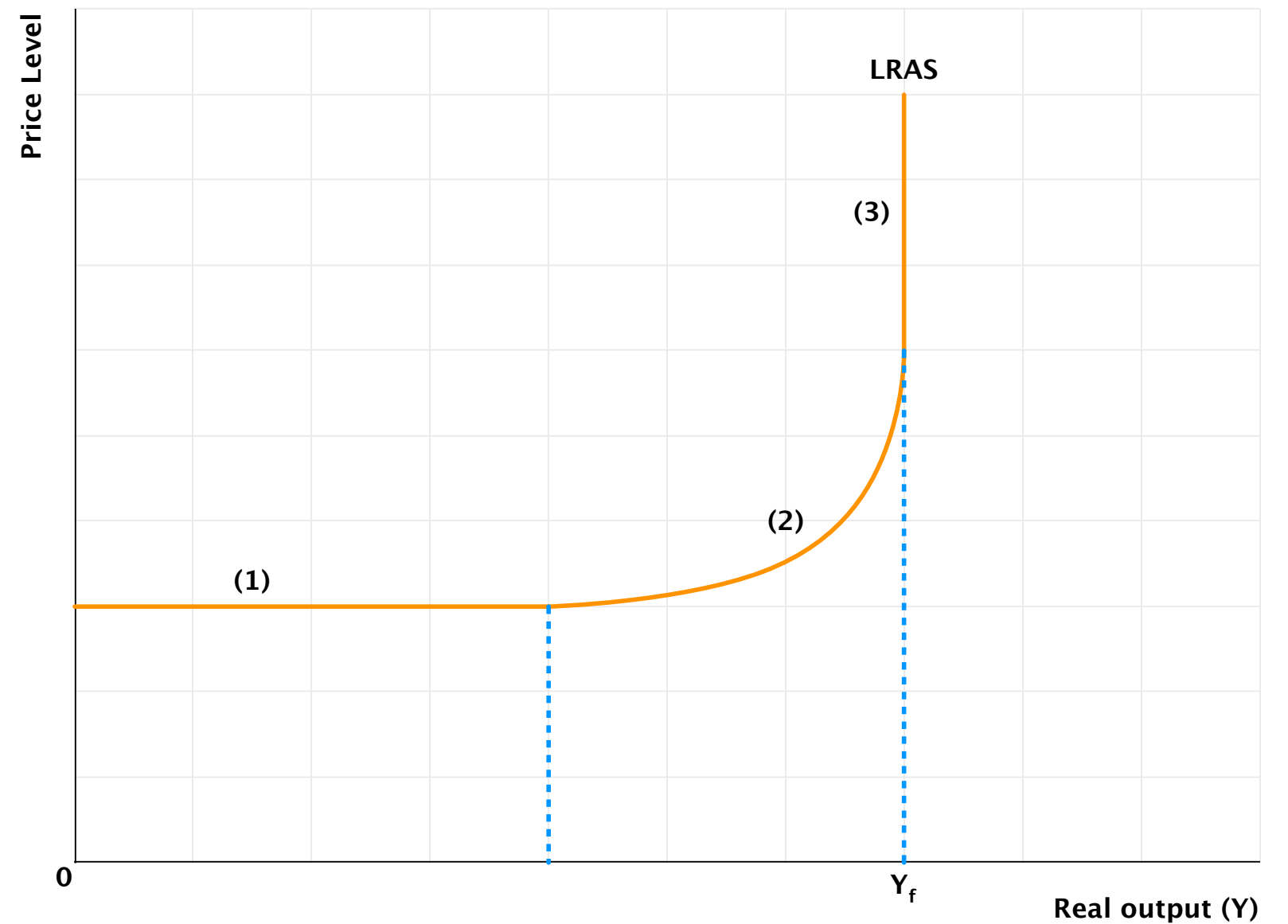
Keynesian LRAS

- In region (2), the LRAS is upward sloping.
- The spare capacity is used up, which cause the PL to increase as output increase (because the factors of production are becoming more scarce).



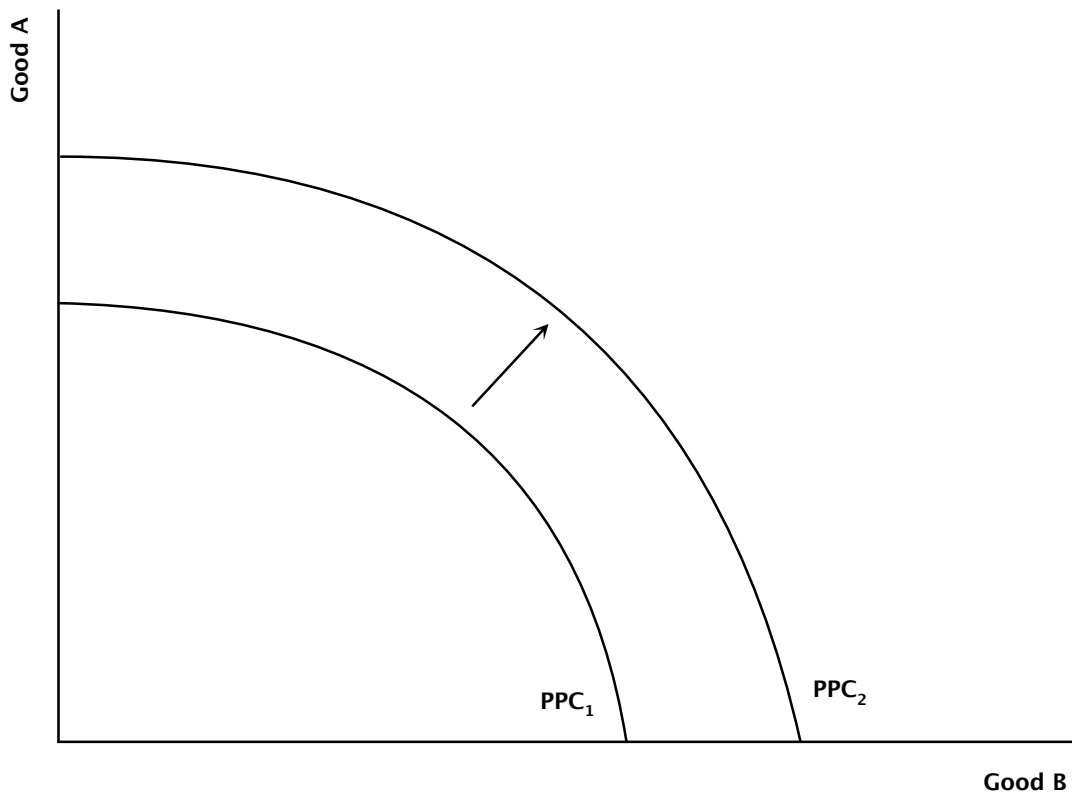
Keynesian LRAS

- In region (3), the LRAS is perfectly inelastic.
- All the factors of production are being fully utilized – just like new classical LRAS.
- Output can no longer be increased using the current factors of production.

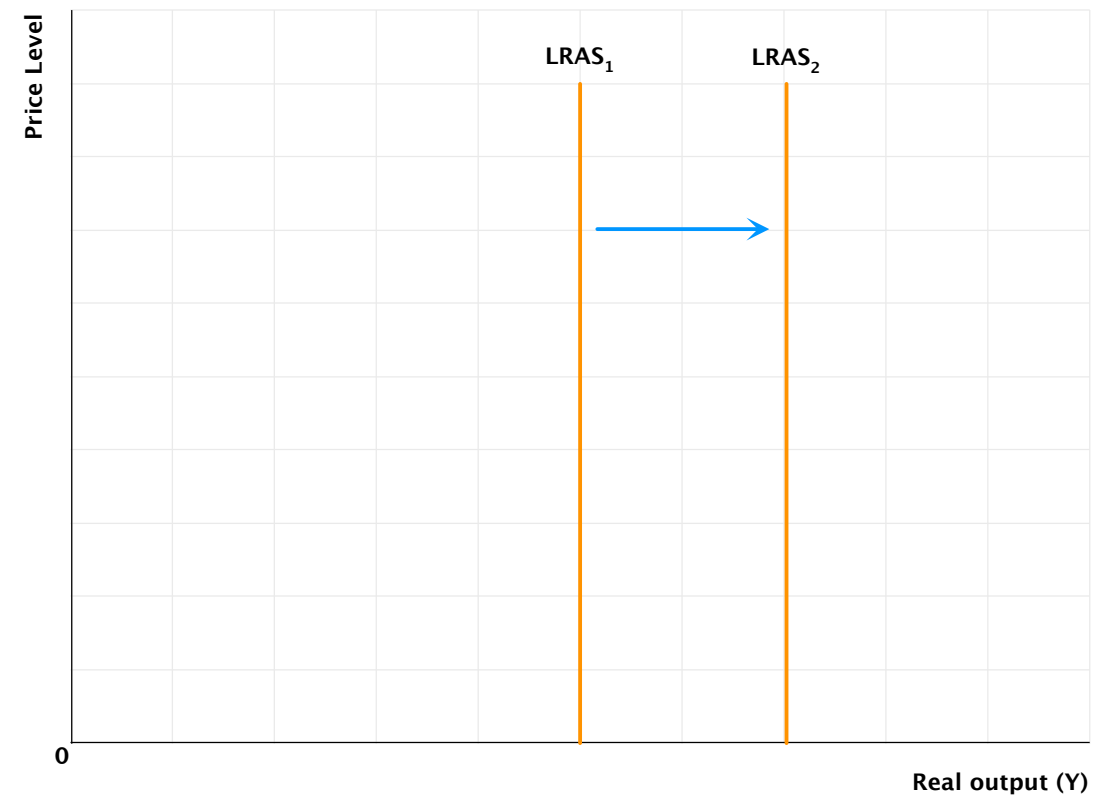


- If there is an change in the quantity or quality of the factors of production, the LRAS will shift.
- Here's what an increase in the quantity/quality of the factors of production would look like on a PPC, new classical LRAS, and Keynesian LRAS:

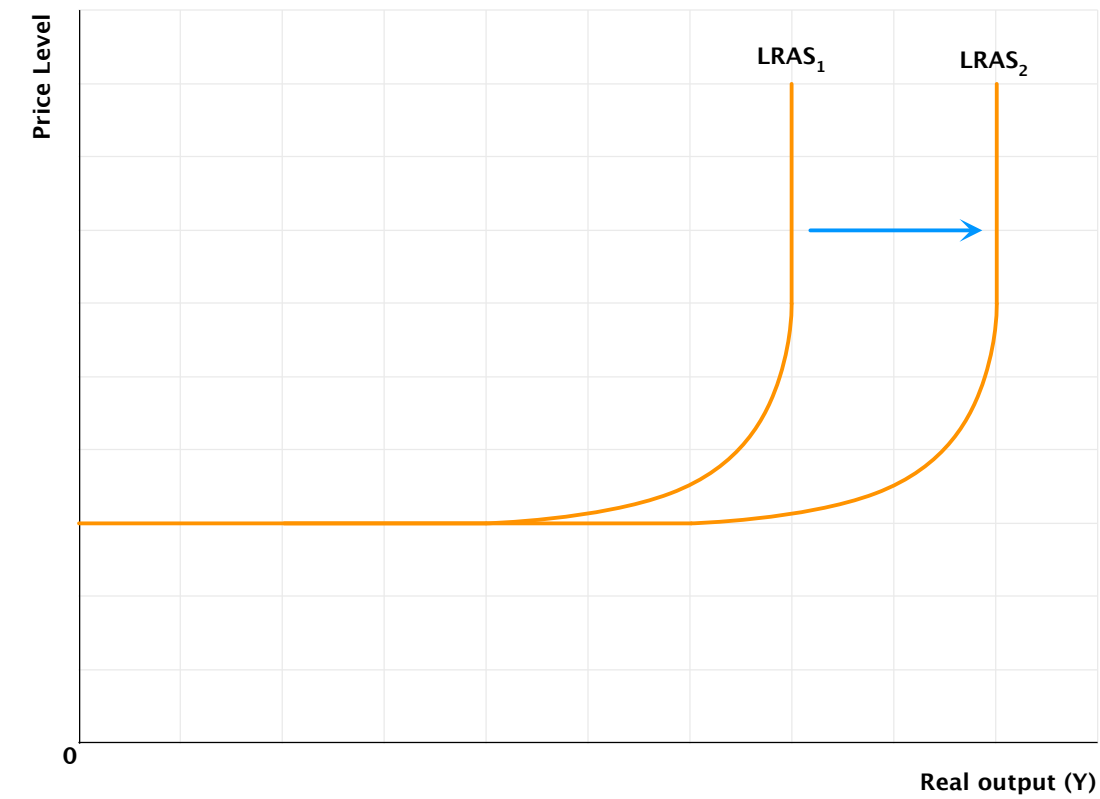
PPC



new classical LRAS



Keynesian LRAS



- They all show an increase in the *potential* output of the economy.

Supply side policy

- The main goal of supply side policy is to increase the potential output of the economy by increasing the quantity/quality of the factors of production.
- There are two types of supply side policies:
 - interventionist policies
 - market based policies

Interventionist policy

- These are based on the idea that the government should actively intervene in the economy to encourage growth.
 - Investment in human capital – education and training.
 - Research and development (R&D) in new production methods and technology.

- Provision and maintenance of infrastructure.
 - infrastructure: large scale capital, usually provided by the government, which is necessary for economic activity to take place
 - roads, electricity, water, sanitation, transportation systems, communication systems, etc.
- Direct support for businesses/industrial policies.

- Each interventionist supply side policy also has an effect on aggregate demand because it involves changes in government spending and/or taxes.
- The AD effect happen quickly, while the LRAS effects take a long time.
- Remember, there is always an opportunity cost for government spending.

Market based policy

- These are based on the idea that the government should not get involved in the economy because the economy works better without government involvement.
- These policies focus on incentives and rules.
 - Reduction of household income taxes – if people can keep more of their money, they will have the incentive to be more productive.

- Reductions in corporate taxes – if businesses can keep more of their money, they will be more likely to spend more on investment and research and development, and they be more productive.
- Labor market reforms:
 - Reduction in trade union power – trade unions tend to increase the cost of production, so limiting them should lower the cost of production

- Reduction or elimination of minimum wages – this would decrease the cost of production.
- Reduction in unemployment benefits – if the government doesn't help people survive when unemployed, people will be more likely to take a job – any job.
- Deregulation – getting rid of rules and regulations (health, safety, working hours, etc.) will decrease the cost of production.

- Privatization – convert government owned firms into profit maximizing privately owned firms.
- Policies to increase competition – more competition means more efficiency.